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ECONOMIC TALKING POINTS

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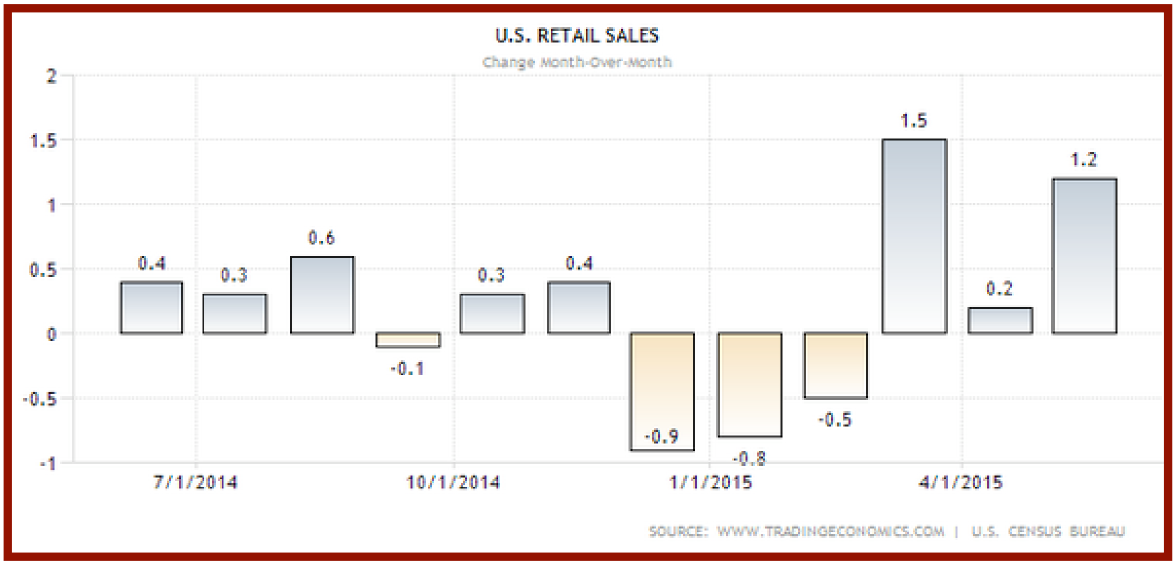
Waiting Until September To Raise Rates Poses New Risks For the Fed

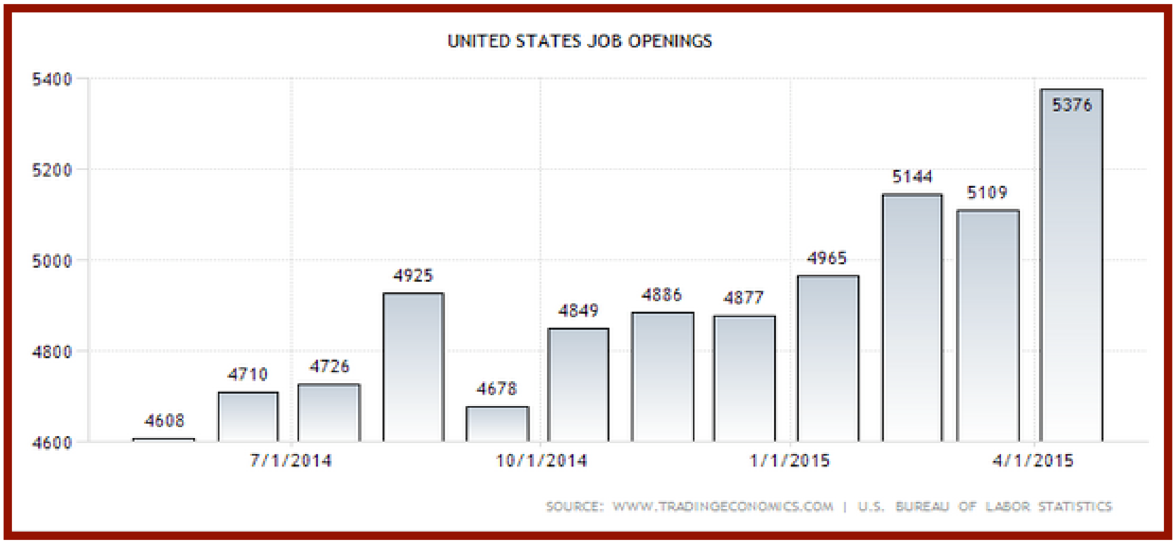
We noted in our previous report that this could be a long hot summer for the Federal Reserve.

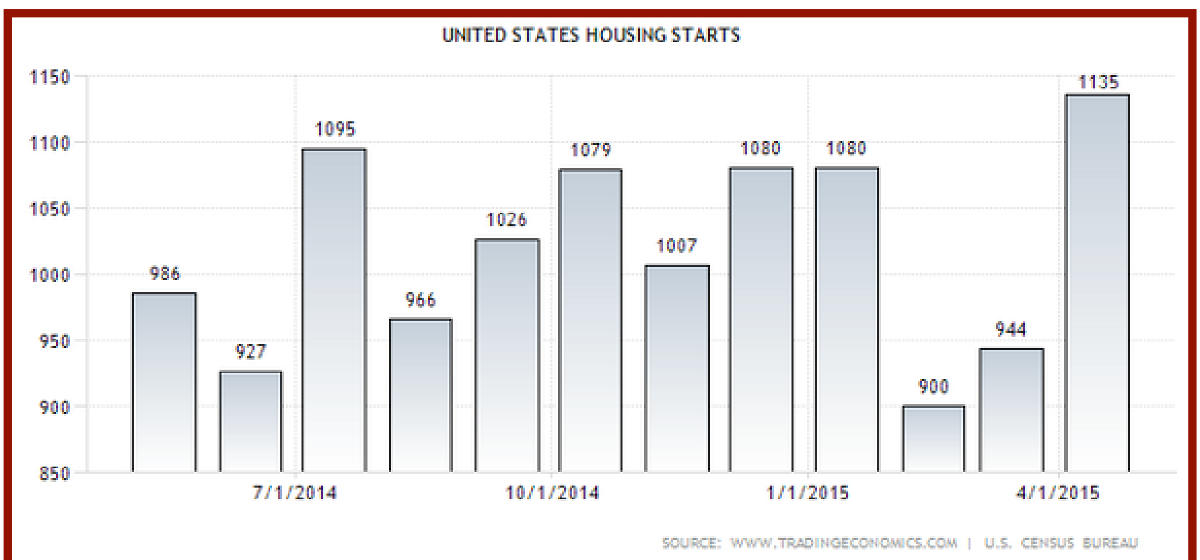
Well, today the temperature jumped up a few more degrees. A torrent of stronger than expected economic reports in recent weeks, along with the rapid climb in bond yields lately, revives the question about whether the Fed should begin normalizing rates as early as next week.

The latest important barometer on the economy was retail sales, which surged 1.2% in May, with all but one of the 13 major spending categories moving higher. Leading the charge were auto sales, building material and garden supplies, clothing, general merchandise stores, and gasoline purchases. The one sector that slipped was spending at health and personal care stores, but then we suspect with jobs and income improving, there is less need for aspirins and stomach aids. The government also revised up retail sales for March to 0.2%, after initially saying it was flat.

Out today, too, was news that U.S. business inventories recorded their biggest increase in nearly a year in April, a reflection that firms were more sanguine about the business outlook, especially since sales jumped by an even greater 0.6%.


U.S. RETAIL SALES
Change Month-Over-Month
2
1.5
1
0.5
0
-0.5
-1
0.4
0.3
0.6
-0.1
0.3
0.4
-0.9
-0.8
-0.5
1.5
0.2
1.2
7/1/2014
10/1/2014
1/1/2015
4/1/2015
SOURCE: WWW.TRADINGECONOMICS.COM | U.S. CENSUS BUREAU


UNITED STATES JOB OPENINGS
5400
5200
5000
4800
4600
4608
4710
4726
4925
4678
4849
4886
4877
4965
5144
5109
5376
7/1/2014
10/1/2014
1/1/2015
4/1/2015
SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS


UNITED STATES HOUSING STARTS
1150
1100
1050
1000
950
900
850
986
927
1095
966
1026
1079
1007
1080
1080
900
944
1135
7/1/2014
10/1/2014
1/1/2015
4/1/2015
SOURCE: WWW.TRADINGECONOMICS.COM | U.S. CENSUS BUREAU

Look, Fed policymakers have repeatedly said that monetary policy will be based on the performance of key economic indicators. If they are in fact "data dependent," then the burden increasingly falls on them to explain why it is appropriate to keep postponing even a miniscule 25 basis point increase.

The consistency of strong economic news on household spending, employment, take home paychecks, auto sales, total loan demand (i.e., consumers and business), small business optimism, construction spending, pending home sales, new home sales, mortgage applications to purchase a residence, job vacancies, manufacturing and service activity (from ISM) ---- all should raise questions whether the Fed can really afford to wait until September to act.

While the FOMC does have a scheduled meeting in late July (and we all know the Fed can theoretically act any time on monetary policy if the situation demands it), I suspect Janet Yellen would prefer to proceed with the first rate increase since 2006 when she can follow up with a press conference to better communicate the FOMC's motivations and perceptions of the economy. That means either lifting rates next week – or delaying any policy change for another three months.

Figuring out the right timing for a rate hike has suddenly become more problematic at the Fed. Here are the issues they now face: Average hourly earnings have been marching higher (May's annual increase of 2.3%, was fastest since the summer of 2013), yet business productivity just keeps plummeting. The combination of the two has driven unit labor costs sharply higher --- and the Fed has to be aware that this increases pressure on companies to raise prices if firms want to protect margins. In other the words, inflation could accelerate faster than the 0.6% to 0.8% the Fed projected for 2015 at its last meeting.

Moreover, the bond market is getting increasingly anxious too. We are now in the midst of a re-pricing for fixed income securities. The yield on the 10 yr bond has risen more than 30 basis points in less than two weeks, from 2.10% at the end of May to 2.44% this morning. We're forecasting it to climb above 2.5% by the end of the month, and near 3.0% year-end.

Inaction by the Fed at a time of more robust economic activity only increases the angst among bond traders who worry the Fed may be slipping behind the inflation curve.

After all, does it make sense for US short term rates to remain near zero when the economies of the US, Europe and Japan are gathering more steam? Just how comfortable are investors holding government bonds at near record high prices, with everyone subtly eyeing the exit door? Will be there be a lack of liquidity once the stampede out of bonds begins? We know banks are much less a player in this market because of new regulations and capital requirements. True, the Fed and the ECB are still buyers of these securities, but they will keep them on their balance sheets and that will take liquidity out of marketplace.

Furthermore, the sheer volume of positive economic data lately has pretty much crystallized the view that we can dismiss the weakness in the first quarter as temporary; indeed, the GDP revision next month could even show the economy never contracted earlier this year. We say this because the government just released a reassessment of spending on services in the first quarter (Quarterly Services Survey), which reported that household outlays on services rose faster than initially assumed in the GDP estimate.

What all this comes down to is that the current economic expansion is a lot sturdier than many thought a month or two ago. Whatever apprehensions Fed policymakers had back then about raising rates in June are less valid now.

We see no reason ---barring any exogenous shock --- why economic activity will reverse course and weaken in the months ahead. Output, incomes, hiring and prices will continue to climb and that is why we believe this could be a long hot summer for the Fed if they don't act next week.

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